Office of Chief Counsel
Internal Revenue Service

memorandum

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RRCorlew

date: FEB 14 2001

to: Rick Cosler, International Examiner, Group 1685
Mirtha Pujol, International Team Manager, Group 1685

from: Associate Area Counsel, (LMSB)
Ft. Lauderdale

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subject: [redacted]
EIN [redacted]
Form 1042

This memorandum constitutes non-docketed significant advice which is subject to 10-day post-review in the Office of Chief Counsel. Therefore, please take no action to implement the advice contained in this memorandum until the expiration of that 10-day period.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the I.R.S. recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to I.R.S. personnel or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on the I.R.S. and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Section 1441(a) of the Code generally requires all persons, who make payments to any nonresident alien individual to deduct and withhold a tax equal to 30 percent. In the subject case, the taxpayer paid foreign investors rental income and failed to deduct and withhold taxes on that income. The taxpayer also failed to file Form 1042 returns as required under the Code. On the investor's returns they reported the income and classified it as "effectively connected income", however, they failed to file a statement to that effect with the taxpayer. Is the taxpayer liable for any withholdings, penalties and interest for failing to deduct or withhold taxes on the foreign investors rental income?

Yes. The taxpayer had a duty to withhold taxes as proscribed under I.R.C. § 1441(a) and there is no exception that would relieve the taxpayer from this responsibility. Therefore, since the taxpayer failed to comply it would be liable for the penalties and interest. The taxpayer will be liable for withholding unless the taxes were paid by the investors. See, I.R.C. § 1463.

FACTS

The taxpayer, [redacted] is a private member owned club incorporated under the laws of the State of Florida. An individual may purchase an "[redacted] membership" which among other things allows them access to the club. A member may also purchase and own property. Many of the properties purchased by the members were used as rental properties. The rental properties [redacted]. The investors consist of both foreign and domestic. In this case, the agents question only concerns foreign investors.

The rental properties at issue were managed and run by the taxpayer on behalf of the investors. The taxpayer received a portion of the rent proceeds and charged a fee for its services. The remainder was paid to the investors. During the taxable years [redacted] through [redacted] the taxpayer made payments to the investors and submitted to the Internal Revenue Service Form 1099's representing rental income paid to each investor. The taxpayer also submitted Form 1099's to each investor.

The taxpayer neither withheld any amounts paid to investors nor prepared or filed any Form 1042 returns to report the tax withheld. According to a phone conference with the agent, the investors reported the income on the returns and classified it as "effectively connected income". The investors, however, did not

file any statements with the taxpayer (i.e., Form 4224) that the income was effectively connected with the conduct of a trade or business within the United States and that the income was includible in gross income for the taxable year.

ANALYSIS

In determining whether the taxpayer has a duty to withhold we first look to I.R.C. § 1441(a). Section 1441(a) requires that all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of income to a nonresident alien individual to deduct and withhold a tax equal to 30 percent. The taxpayer in this case was engaged in the business of managing rental property on behalf of the investors. After the taxpayer collected the rents the investors were paid a percentage of the net rental income. Based on these facts the taxpayer was responsible under I.R.C. § 1441(a) for withholding tax from the investors.

Next, we determine whether the taxpayer qualifies under I.R.C. § 1441(c) for exception from withholding responsibility. Section 1441(c)(1) provides that no withholding is required on any income item which is effectively connected with the conduct of a trade or business within the United States and which is included in the recipient's gross income under I.R.C. § 871(b)(2).

In order for I.R.C. § 1441(c)(1) exception from withholding to apply, the regulations require that the person entitled to the income file with the withholding agent a statement showing that the income is effectively connected and includible in his gross income for the taxable year. In addition, the statement shall be filed before payment of the income in respect of which it applies. Treas. Reg. § 1.1441-4(a)(2). The regulations provide that a properly executed Form 4224 will satisfy the required statement.

The regulation at issue § 1.1441-4(a)(2) requires strict judicial deference because it is an interpretative regulation. Rowan Cos v. United States, 452 U.S. 23 (1981). Although, I.R.C. § 1441(c) is silent regarding the filing of Form 4224 the regulation clearly states that Form 4224 or equivalent statement must be filed with the withholding agent so that the recipient may receive the income free of withholding. We believe that the regulation does not impose an unreasonable burden on either the taxpayer or investors and should be applied accordingly.

In our previous phone conference the agent expressed some reservations about whether the withholding duty should apply

because the investors had paid the tax. It was my impression that perhaps the agent felt that this is not what the legislature intended because it may create an unreasonable result. The regulations are very clear as to the precise question at issue. Thus, we need not engage in interpreting the legislatures intent or deciding its reasonablility nor is it necessary to elucidate a specific provision because the regulation is very clear.[1] The regulation requires that a statement be filed with the withholding agent in order to receive rental payments free of withholding. The investors failed to file any such statement for any of the years at issue. Therefore, since the taxpayer failed to meet the requirements of Treas. Reg. § 1.1441-4(a)(2) for the years as issue, no Form 4224 was filed, we conclude that the taxpayer is not excepted from I.R.C. § 1441(a) withholding duty. Accordingly, the taxpayer cannot avail itself of the I.R.C. § 1441(c)(1) exception from withholdings.

This is the result the legislature intended in the application of this regulation. Since the taxpayer never received the Forms 4224 from the investors as required by § 1.1441-4(a) of the regulations, the exception under I.R.C. § 1441(c)(1) does not literally apply and the taxpayer was required to withhold the 30 percent tax. FSA 1999-05-005 (Oct. 28, 1998)[2].

Our position is further supported in the case of Casa de la Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990). In La Jolla the individuals who received income failed to properly file Form 4224. The issue was whether the petitioner is responsible under I.R.C. § 1441(a) for withholding tax on interest income of its nonresident alien sole shareholder. The Court held that because the petitioner failed to meet the requirements of Treas. Reg. § 1.1441-4(a)(2) of the regulations, in that no Form 4224 was filed, the petitioner was not excepted from its duty to withhold tax on interest paid to a nonresident alien. See also, Housden v. Commissioner, T.C. Memo 1992-91.

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[1] For a discussion of interpretative regulations see Nations Bank v. Variable Annuity Life Insurance Co., 513 U.S. 810 (1995); Chevron U.S.A. v. Natural Resources Defense Counsel, Inc., 467 U.S. 837 (1984).

[2] The FSA involves a taxpayer who failed to withhold on rental income and no Forms 4224 were filed. The analysis and conclusion in the FSA support the opinion in the subject case.

Now that we have determined that the taxpayer is not excepted from the withholding duty we must determine if the taxpayer will be liable for penalties and interest. You informed us in a previous phone conference that the income taxes may have been paid by the investors. To the extent that is correct the taxpayer would not be liable for the tax. They would, however, not be relieved of penalties and interest. Section 1463 of the Code provides that if a withholding agent fails to deduct and withhold tax as required and the tax has been paid, then the tax shall not be collected from the withholding agent, but in no case shall this section relieve such person from liability for interest or any penalty or additions to the tax otherwise applicable.

The withholding mechanism discussed in this opinion is clearly one of compliance. The withholding agent is primarily liable to the IRS for any amount required to be withheld and failure to do so will subject the withholding agent to penalties and interest. In the subject case the taxpayer was in violation of the withholding requirements because he failed to withhold. Therefore, the taxpayer will be liable for penalties and interest as prescribed under I.R.C. § 1463.

After the tax has been withheld the withholding agent is required to deposit the withholding tax in a Federal Reserve or other authorized bank. I.R.C. § 6302. The withholding agent also must file an annual return on Form 1042 and a Form 1042S with respect to each foreign recipient. Therefore, the taxpayer in this case will be liable for penalties under I.R.C. § 6651(a) for failure to file an income tax return and I.R.C. § 6656(a) for failure to make a deposit of tax.

Since there is no further action necessary from this office, we shall close our file subject to reopening if necessary.

If you have any further questions, please contact the undersigned at (954) 423-7946.

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